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South Korea: Prospects for Growth

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Summary

South Korea has been touted as the "next Japan"--a reflection of its economic success over the past 25 years and its efforts to move into knowledge- and technology-intensive industries. But Seoul faces obstacles Tokyo never had to contend with--such as a smaller domestic market, a heavy defense burden, and much stiffer world competition. The country is currently experiencing its most serious economic slowdown since 1981, and Seoul is experimenting with pump-priming measures to get it moving again. Despite South Korea's large foreign debt, we believe the economy is basically sound and future growth should be strong by world standards--albeit below what South Koreans have become accustomed to. Economic growth will be determined largely by factors outside Seoul's control, however--such as demand for Korea's exports and protectionist

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barriers. Moreover, continued subpar economic performance would likely contribute to domestic political tensions, which in turn may further restrain future growth by undermining foreign lenders' and investors' confidence in South Korea's economy. [REDACTED]

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South Korea's Growing Industrial Strength

An aggressive private sector aided by government support and a low-paid but productive work force have made South Korea the world's 15th-largest exporter and perhaps its most advanced LDC. An underdeveloped agrarian society 25 years ago, South Korea has become competitive in several highly visible industries important to the economies of the developed countries. The growth of South Korea's industrial strength is reflected in:

- Shipbuilding. South Korean shipbuilders captured 15 percent of worldwide orders in 1984--second only to Japan.
- Steel. South Korea has become the world's most competitive steel producer by combining low wages with technologically advanced plants. It plans to increase capacity by 75 percent over the next decade.
- Overseas construction. Orders grew an average of 28 percent annually between 1975 and 1983, but have decreased as oil prices have declined. At their peak in the early 1980s, South Korean firms accounted for over half of the world's 25 largest general building contractors. [REDACTED]

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Building on these successes, South Korean economic planners have targeted rapid expansion into knowledge- and technology-intensive industries:

- Automobiles. Seoul plans to boost automobile exports from 43,000 units in 1984 to 800,000 by 1991 using efficient, up-to-date assembly lines now being constructed. Hyundai will begin selling cars in the United States by early 1986, and Daewoo, strengthened by a technical and equity tieup with General Motors, is tripling its capacity.

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- Semiconductors. Samsung and other leading electronics firms intend to begin producing 64K and 256K random-access memory chips and are eyeing the 1-megabit-chip market. The South Koreans could apply this technology to the production of other advanced electronics. 25X1

Astute economic planning, aggressive business strategies, and a well-disciplined and -educated work force are pluses for Seoul's ambitious industrial strategy. The many underemployed college graduates and Koreans residing overseas also are an untapped pool of talent. Seoul will be better able to encourage the inflow of new technology and to foster domestic as well as foreign investment because of its ongoing liberalization of foreign investment, technology transfer, imports, and the financial system. 25X1

South Korea--Not Another Japan

Despite the comparisons made between Japanese and South Korean economic successes, however, South Korea must cope with hurdles not faced by Japan two decades ago:

- Small domestic market. A population of only 40 million and a \$2,000 per capita income do not provide a South Korean domestic market large enough to be a springboard for many emerging industries, forcing reliance on foreign markets.
- Dependence on foreign inputs. Lacking a mature R & D infrastructure, South Korea depends upon foreign technology and capital for even rudimentary development of new industries.
- Protectionism. Forays into technology-intensive exports will result in head-to-head competition with developed trading partners. Frictions will inevitably increase in areas such as intellectual property rights, trade in services, and strategic trade controls.
- Security issues. A relatively heavy defense burden--nearly 6 percent of GNP--acts as a brake on Korea's economic growth and channels scarce technical expertise from commercial endeavors, impeding South Korea's climb up the technology ladder.
- Foreign debt. South Korea must manage a \$45.3 billion debt--over half its GNP. Additional capital inflows could be at risk if foreign bankers became more concerned over South Korean political stability. 25X1

South Korea's difficulty in negotiating these obstacles has been evident in 1985, its worst year for economic performance in four years.

- Real GNP growth tumbled from a spectacular 12.6-percent annual rate in the first quarter of 1984 to 2.7 percent in the second quarter of 1985.
- Negative export growth in the first half of 1985 pulled growth down, while austere fiscal and monetary policies stifled domestic demand and investment.
- Seoul's foreign debt grew faster than planned, with its \$45.3 billion tally in July exceeding by \$200 million the overall target for 1985.

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Seoul's economic technocrats have instituted--albeit belatedly--a pump-priming package that includes:

- Expanding the money supply at about 150 percent more than the planned rate, increasing business loans, and paying off the bad debts of the corporate sector.
- Boosting government spending by \$292 million in a supplemental budget and proposing a 10.2-percent growth in 1986 budget outlays.
- Aggressively devaluing the won to bolster export competitiveness.

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Prospects

These measures signal Seoul's willingness to respond to economic problems with flexibility, but we see no signs of panic or hasty policy shifts. Economic planners continue to favor programs that position South Korea for future growth by augmenting domestic investment and promoting exports, rather than "quick fix" solutions. We believe Korea probably will post real GNP gains of 3.5 to 4 percent this year, and nearly 6 percent in 1986.

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On balance, then, we are cautiously optimistic about South Korea's near-term growth prospects, but future economic performance is largely outside Seoul's control. Prospects for the economy in 1986 and beyond could be clouded by slow economic growth and protectionist barriers in developed countries that could stifle export growth and damage Korea's international credit rating; bankers' confidence in South Korea is largely predicated on a rate of export growth that reduces Seoul's debt burden.

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Domestic political tensions will also influence the course of economic progress through the rest of this decade. Recent student protests and ongoing confrontation between government and opposition politicians underscore the high potential for political turbulence and the volatility of the Korean scene. In our judgment, the economy has not yet suffered from the effects of perceived or real political instability. Foreign and domestic businessmen have maintained confidence in Korea's long-term international competitiveness and ability to manage the economy, but episodes of political tension over the next year or so could erode their faith in the economy and prompt a slowdown in capital and technology inflows that are essential for future growth and enhanced competitiveness. [REDACTED]

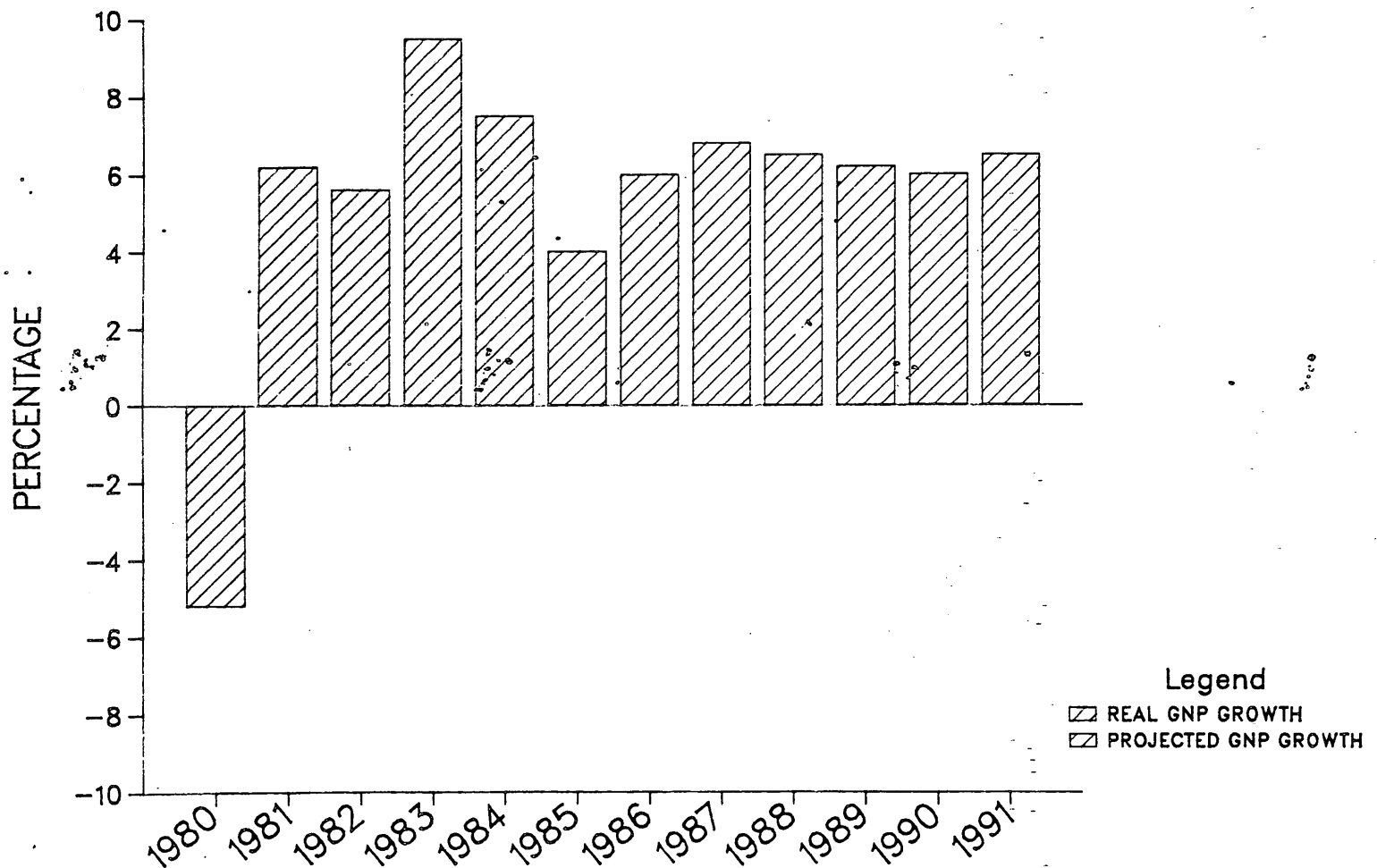
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Moreover, continued subpar economic performance would likely fuel rising domestic political tensions, in turn prompting an erosion of confidence in the South Korean economy by both domestic and foreign interests. In the longer run, the uncertainty about an anticipated leadership transition in 1988, when President Chun Doo Hwan has promised to step down, also causes some concern. Accumulating political strains or worries about an aborted succession could prompt foreign lenders and investors to view Korea as too risky. [REDACTED]

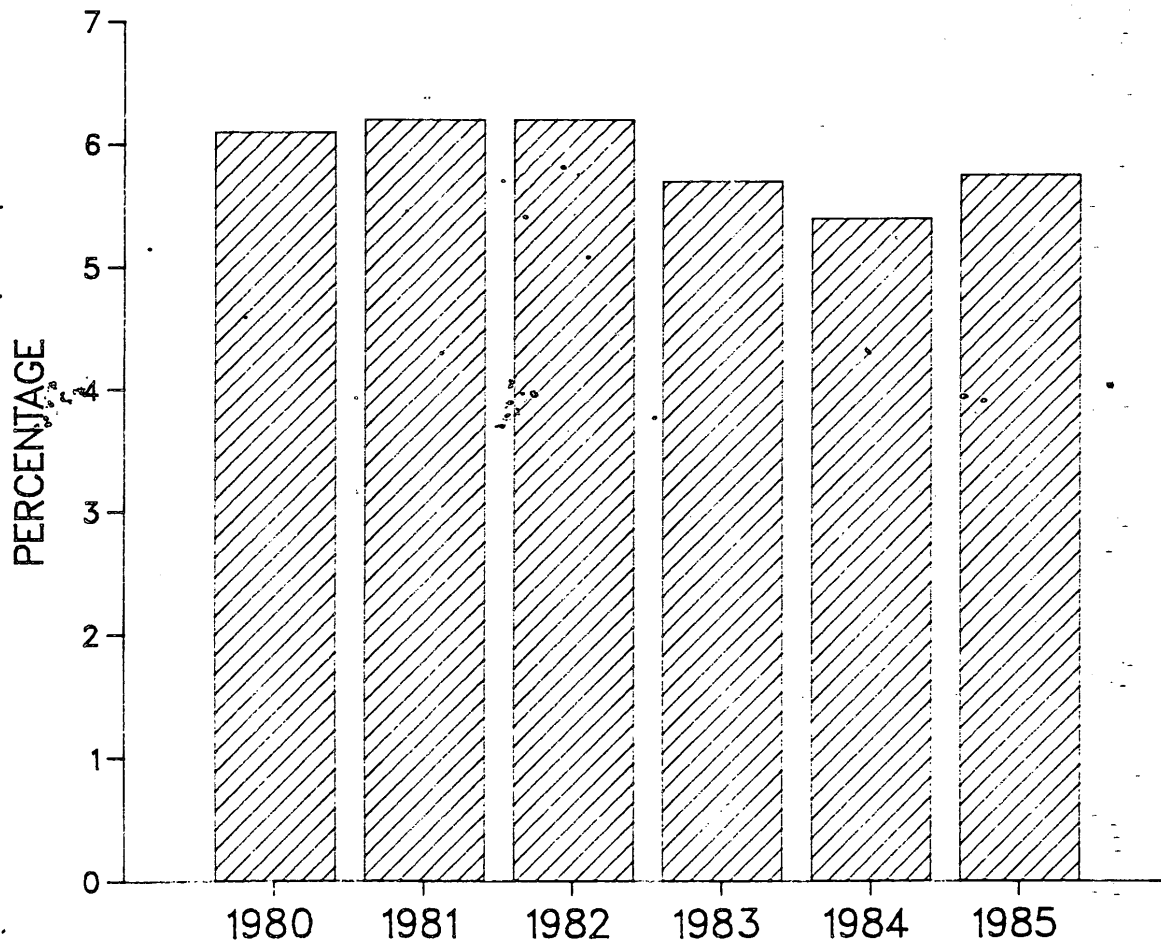
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GROWTH OF SOUTH KOREA'S GNP 1980-91



SOUTH KOREA: SHARE OF GNP FOR DEFENSE SPENDING 1980-85



**OUTLOOK FOR MAJOR SOUTH KOREAN INDUSTRIES
1985 TO 1995**

INDUSTRY	PERFORMANCE RATING			COMMENTS
	1985	1986-1988	1989-1995	
Steel		●	●	A turnaround in shipbuilding, coupled with strong growth in automobile manufacturing, will ensure strong domestic demand for steel...continued steel export restraints and excess world steelmaking capacity cloud the export outlook.
Shipbuilding	●	●	●	Demand forecast to pickup in late 1980s...Korean yards will be in good position to secure a big share of new orders.
Overseas Construction	●	●	●	Wage advantage eroding fast...lack technical expertise for complicated contracts...may bounce back if developing countries undertake large infrastructure projects.
Automobiles	●	●	●	Strong growth assured as Korea expands its role as an offshore production base for primarily US auto firms...state-of-the-art factories, coupled with wages one-tenth those in the United States, augur well for competitiveness and profitability.
Semiconductors	●		●	Lack of technical expertise and a strategy to leap-frog technology into 64K, 256K and 1-megabit chips will pose difficult challenges as the industry gears up.
LEGEND	● Poor ○ Fair ● Good ● Excellent			Performance ratings are based on CIA projections of industry growth prospects, international competitiveness, and profitability. Greatest weight given to growth and competitive factors.

Computers	●	●	●	Capable of indigenous production of all but most sophisticated components...high value added and wages in electronics industry among lowest in Korea...dependent on US-Japanese-European technology.
Consumer Electronics	●	●	●	Near lowest wages for all manufacturing... highly skilled, disciplined work force well suited to detail work...large, recent investment in modern plants.
Heavy Machinery				Sinking along with overseas construction...poor export outlook.
Machine Tools	●	●	●	Growing in sophistication...Japan moving into higher end of machine tools and robotics...leaves possible niche for Korea.
Textiles and Apparel		●		Intense price competition from Asian LDCs will erode Korea's advantage in long run...recent investment will benefit producers in the medium term...protectionist moves could cripple industry ...successful move up market will forestall decline.
Footwear	●	●		Intense price competition from Asian LDCs will erode Korea's advantage in long run...protectionist moves could hasten decline.

SUBJECT: South Korea: Prospects for Growth [REDACTED]

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